April 15, 2003

Mayor Locke and Council Members:

Attached herein is the Manager's Recommended City and Schools Budget for FY 2004 totaling **$326,137,242**, a **5.71** percent increase over the current FY 2003 budget. The Schools portion of this budget is $159,461,565, a 4.01 percent increase over FY 2003.

Each budget year we stress to you the difficulty of preparing a budget recommendation. You are all aware of the State's ongoing budget difficulties. The State's problems have been well documented and debated over the last year. As a result of reduced revenues, the State has continued to reduce its reimbursements to mandated services, hoping to shift its burden to localities. Many localities, including Hampton, have responded by refusing to make up State cuts. While impacted services are important, localities should not be expected to and can no longer afford to make it easy for the State to pass on cut after cut to localities. Thus, you will note some decreases to constitutional offices and other city-state offices as well as the public library in this year's budget. Those cuts are the responsibility of the State and the State alone. The City has not made reductions beyond those imposed by the General Assembly.

State fiscal problems not only resulted in major reductions in state reimbursements to localities but also caused there to be no progress in the improvement of state funding for required activities such as education. An independent Joint Legislative Audit Review Commission (JLARC) study commissioned by the General Assembly confirmed what localities have said for years – that the State is inappropriately underfunding education. The JLARC study found the State was under funding education by a minimum of $1.1 billion. If the State's funding of education were to be adjusted to reflect current SOL requirements and prevailing educational practices, the funding deficit would grow to $2.8 billion.

Because of the State's failure to appropriately fund education, the City of Hampton has had to put more local dollars into this critical area than we should have to fund. As one example, JLARC found that if the State adopted the JLARC corrective measures, the local school system would receive in excess of <u>$30 million</u> more for education <u>each year</u>. With full and appropriate State funding of education, the City could more readily and easily fund other community priorities such as public safety, neighborhoods, parks, recreation, etc., all without raising fees and/or cutting back on existing City services.

However, even though JLARC clearly established the State should be funding more in education and transportation, the General Assembly failed to make any real progress on addressing these needs. Indeed, the General Assembly took several steps backward when it balanced the State's budget on the backs of localities and school systems yet again. The budget passed by the General Assembly reduces funding to the City of Hampton by approximately $1.06 million. Where we could, these cuts were passed onto the relevant agency for the reasons cited above. However, the cuts also directly impacted our unrestricted revenues. ABC profits, wine tax receipts, recordation revenues and HB599 reimbursements were all significantly reduced, resulting in less revenue with which to work. Since these revenues are not directly tied to a specific program or activity, there was no corresponding appropriation reduction that could be made, and that meant State cuts created a budget gap before we even considered local Council priorities such as education funding, competitive employee compensation and strategic investments.

The City of Hampton is not isolated in what it is experiencing. Several urban Virginia cities are wrestling with balancing their budgets on the backs of State budget cuts and modest growth in local revenues. Many of these localities are faced with having to raise taxes, fees and/or cut services that affect the elderly and youth and reduce their needed workforce in order to balance their budgets. Indeed, we have all made sacrifices each of the last several years to compensate for the effects of the State actions. Last year, several area localities raised their real estate tax rate – one neighboring city, for instance, adopted a 3 cent tax increase. We did not increase the real estate tax rate but managed by only continuing to chip away at departmental budgets. Those reductions were done with much trepidation as departments were beginning to resist, and rightfully so, the constant tug at their operating budgets. Departmental operating budgets have not increased in more than five years, in spite of increased workloads and responsibilities.

Last year, when we took those additional cuts to avoid a tax increase, *we also warned that we could not continue to expect our operating departments to sacrifice the quality of their service and morale of their workers to make up for the State's failure to demonstrate leadership and responsibility.* Our employees are good stewards and will do anything they can to provide superior service to our residents. We all want to do all we can to avoid a major tax increase. But, the limits of our ability to do so have been sorely tested. We said then: "the State must step up to the plate, or be made to step up to the plate, to fundamentally restructure the tax and service system in Virginia if we are to have any hope of avoiding real estate tax increases in the future". Unfortunately, as we have all seen, that did not happen this year. "Money Management" in its April issue, demonstrates that Virginia is not a high tax State but, in fact, is ranked 40th (10th from the bottom). By the magazine's calculation, the average state and local tax burden in Virginia is 8.9 percent compared to the national average of 9.7 percent.

Having set forth the challenges we, and all cities face, let me turn to a summary of the critical decisions and recommendations contained in the FY 04 budget proposal.

Funding Base Budget Requirements

Total natural growth in local revenues was $7.7 million, a 4.6 percent increase over FY 2003. Once we reduced the growth in local revenues by the loss of State revenues ($1.08 million), we were left with $6.6 million in local revenues to pay for mandated increases, new initiatives and to consider making up State cuts. Mandated increases to the base budget include the following:

- $1.73 million increase committed to the School System as our local, formula-driven, funding contribution;
- $3.3 million in salary requirements added to the base budget for annualized merit pay granted at different intervals during FY 2003, as well as position upgrades and the substantial mid-year market pay adjustments for public safety sworn positions, along with the associated benefit costs;
- $2.5 million added to cover other mandated expenses including: the full-year cost of five police officers and twelve medic firefighters added at the half-year interval during FY 2003; rising regional jail and transit payments; debt service requirements; increases in other benefit costs such as separation pay and accrued payroll; and increases in departmental fixed costs such as auto and general liability insurance, depreciation, and vehicle and equipment repairs.

After funding these required expenditures, we were faced with a budget shortfall of approximately $1 million before we could begin to fund any new items in this budget. In other words, the natural growth in revenues was consumed by mandated increases to the budget before we could fund any new initiatives, such as additional police and medic-firefighter positions, employee compensation, etc.

In order to fund any new initiatives then, we had to consider service reductions and/or tax increases. While we could have taken the approach of not funding anything new, we know that would have been a mistake. There are some basic needs – such as the expansion of our police, fire and emergency medical staff and competitive compensation – that are critical and should be funded, even at the expense of other service reductions and/or tax increases.

Organizational Efficiencies

To minimize the negative effect these choices have, we expanded our traditional approach of tightening our belts by re-evaluating the need for all our positions and services. In fact, recognizing the inevitable problems we would be facing in FY 04 early on in the FY 03 fiscal year, I took the step of convening a Budget Organizational Efficiency Taskforce in October. This task force consisted of a mix of employees with analytical skills, department heads and other key staff. They met weekly considering any idea submitted for consideration from the entire workforce. This "zero-based" budget review netted some internal savings and/or budget reductions we felt were painful but acceptable. As a result of their review, we were able to generate $4.7 million of savings that were applied to the FY 04 budget scenario. The recommendations which led to these savings include:

- Joint purchasing of fuel with Hampton Roads Transit
- Standardization of fleet purchases
- Standardization of computer purchases
- Establishment of a more stringent computer replacement policy
- Institution of more restrictive travel policies
- Tightened sick leave utilization review and implemented incentives for saving sick leave and over-time, all to increase productivity
- Implementation of "reverse auction" bidding on selected supplies
- Refinement of attrition calculations

- Funding one-time needs with anticipated departments' accumulated savings (ex. Harbour Centre garage and Homeland Security matching grant funds)
- Refinement and fully charging indirect costs to outside funds/entities
- Maximization of UDAG and bond interest revenues
- Closure of the City Hall One-Stop in the Mall
- Restructuring of departments into 4 oversight/planning groups for tighter review and future fiscal planning

Again, the total savings generated from these internal "belt tightening" actions was nearly $4.7 million.

Other internal measures were still needed to close the budgetary gap. Actions such as the deferral of some capital projects (e.g. the next phase of soccer fields and some building maintenance) and splitting the cost of some projects over two years (e.g. Clerk of Council technology improvements; zoning ordinance updates; fleet management improvements) were taken were possible to reduce the gap even further. These measures saved another $1.1 million.

The combined effect of these actions generated some limited capacity to fund the majority of the cost of such high priority initiatives as competitive employee compensation, new public safety positions as well as increased mandated costs for juvenile detention. With this capacity, we chose to fund the following new initiatives:

New Budget Initiatives

- **Employee Compensation ($4.2 million)**
  As was promised, this budget includes a significant pay adjustment for all employees. Most years, we typically spend about $1.2 million for pay and employee benefit adjustments. However, this year's allocation is more than 3 times the usual amount. Such an adjustment is appropriate since our overall employee compensation package has fallen slightly below the region in past years. While we have not had major retention or recruitment problems, our employees have nonetheless become increasingly dissatisfied with a pay system that had no accommodation for or recognition of longevity and with an organizational culture that demands more work with less people. An external compensation consultant was hired and this budget implements the first phase of the consultant's recommendations.

  Longevity pay adjustments of $200 for each three years of service will be added to base salary on July 1, 2003. From that point forward, longevity salary adjustments of a like or higher amount will be given to employees.

  The budget also funds a 3.5% salary adjustment for every employee (including part-time and WAES) that will be given on July 1, 2003 in lieu of merit pay for one year. Suspending merits for one year will give us time to significantly strengthen the objectivity and evaluation measures used in the merit system and will allow us to convert all employees to a common evaluation period. All employees will be simultaneously rated in the last quarter of each fiscal year for merit pay changes that will be given on July 1st of all future fiscal years. A common evaluation period will enhance the rating system. We will also move to a 1%-2%-3%-4%-5% rating system with five tiers over this period to allow for more differentiation in the performance ratings of employees.

In addition, we will also be splitting the cost of a 16% health insurance increase 50/50 with employees.

Finally, the compensation budget includes modest funds for a revamping of the sick leave program. To encourage people to save their sick leave for future use and to minimize unscheduled leave, we will change the reimbursement rate for unused sick leave from $5 to $20 a day, up to a maximum of 90 days for all employees with 5 or more years of service upon resignation from the City. Reimbursement rates for retirees remain unchanged. We will also institute a sick leave optimization bonus. Each six months, any employee (excluding management) who has not used any sick leave will be entered into a drawing for a cash bonus. Ten employees will earn $350 for having had perfect attendance.

- **Public Safety Positions and Equipment: ($523,000) -**This budget funds 12 new medic-firefighters and 5 new police officers for a half-year, plus funds for advanced life support equipment and equipment for the new officers. Full year collection of the emergency medical fee will largely offset this cost.

- **Juvenile Detention Costs ($294,000) -** Additional funds are required to cover the cost of juveniles to be placed in a new larger juvenile detention facility.

- **Convention Center Marketing ($392,000) -** Increased funding is being proposed to begin actively marketing the Hampton Roads Convention Center which will open in FY 2005. In order to assure that we have conferences booked in the year construction is completed, we must market our center now as many of the conventions we hope to attract book up to five years in advance. This is the third year of a multi-year marketing budget build-up.

- **Hampton History Museum and Lindsay Community Center Support ($150,000)** – While these facilities are scheduled to open in late FY 2003 and some monies were budgeted in the FY 03 budget, full year operational costs were delayed until FY 04. While there will be admission charges and/or programs fees, additional costs are required above the revenues generated to operate these facilities for the entire year.

- **Other Increases ($2.1 million) –** This budget also includes funding for a variety of critical expenses including, but not limited to, terrorism risk insurance; comprehensive services act requirements; a circuit court docket clerk; a zoning ordinance update; the new Hampton Housing Venture program previously authorized by Council; and, a new technology enhancement for the Clerk of Council.

Although we used approximately $5.8 million in internal budget cuts to balance this budget, it was still necessary to recommend two tax increases and four user fee increases to fund all of these needed investments in our community. The taxes and fees this budget raises are:

<u>Tax & Fee Changes</u>

- **Cigarette Tax ($988,901):** The cigarette tax is being raised by 15 cents, from 40 cents to 55 cents. A recent move by the General Assembly to cap local cigarette tax rates motivated many localities in this region to raise their rates mid-year. Hampton did not but we are proposing this increase now to fund the priorities listed above. The 55 cent per pack rate will be comparable to the region.

- **Solid Waste Fee ($1,000,000):** The general fund still continues to subsidize the Solid Waste operation to the tune of $2,000,000. Other localities have substantially higher solid waste user fees and no longer subsidize their Solid Waste operation with general funds. Neighboring Newport News, for instance, has a rate of $3.98 per week and may raise that fee yet again. Accordingly, it seems prudent to raise the Solid Waste User Fee to reduce its reliance on the general fund for subsidy by 50%. The rate will need to rise by $1.00; $.50 to make up for a reduction in general fund support and $.50 to cover necessary increases in the Solid Waste fund such as depletion of the landfill and the compensation package. The $1.00 increase per week will result in a $52 per year increase to the average homeowner.

- **Various Recreational Fees ($88,000):** This budget adjusts existing recreational user fees, mainly shelter and park rental fees.

- **Real Estate Tax ($1,695,000):** Hampton has resisted the temptation to raise the real estate tax for many years – even while other localities were raising theirs. It was raised two cents in FY 2002 and the last time before that was 1998; both times for either school or public safety expenditures. In other words, a general fund tax increase for non-school and non-public safety expenditures has not taken place since fiscal year 1995. A real estate tax increase is always hard to propose but its effect is modest on most homeowners (for a house currently assessed at $100,000, the increase would be as follows: $62.99 for reassessment and $31.49 for tax rate increase, for a total of $94.48 which is generally paid for through escrowed mortgage and is income tax deductible). It is the only source of revenue large enough to generate the needed funds to do the competitive employee compensation package we all know is compellingly warranted.

- **Other tax and fee increases to support Non-General Fund Departments are as follows:**

    - **E-911 Fee** is increasing from $2.50 per telephone line to $2.60 per telephone line to pay for increased volume of Wireless 911 calls and employee compensation for employees who support the activities of this fund.

- **Sewer User Fee** is increasing from $.82/HCF to $1.07/HCF to support the employee compensation package for employees of this fund, pipeline repairs and building renovations.
- **Stormwater User Fee** is increasing from $$2.50/week to $3.00/week to support the employee compensation package for employees of this fund and building renovations.

In summary, once again a frugal budget is being presented to you. While it does not eliminate or reduce major City services, the budget does defer some important items and institutes a few tax and fee increases. Much, if not all, of this pain would have been avoided had the State acted more responsibly over the years. Full state funding of education and activities it mandates would allow more than adequate local flexibility to meet our community needs and desires without fee increases and position eliminations. I hope this budget, along with the compelling JLARC studies that highlight State funding inadequacies, will be a call to action for our employees, residents and elected officials to compel the State to correct its deficiencies. If the State continues to push down its responsibilities, we will come to the point of being forced to reduce or eliminate services until our economic investments in high wage jobs (National Institute of Aerospace), retail (Power Plant) and tourism (Crossroads/Convention Center) pay off.

I look forward to working with you as begin the budget deliberations. My staff and I are available to address any questions or concerns you may have regarding this budget recommendation.

Respectfully Submitted,

George E. Wallace

George E. Wallace
City Manager